EXECUTIVE SECRETARIAT
ROUTING SLIP

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13	D/Pers				
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15	D/PAO				
16	SA/IA				
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19	NIO/ECON		✓		
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SUSPENSE ____________ Date

Remarks

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D/Executive Secretary

9/5/84
Date

3637 (10-81)

OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

Executive Registry
84-8065

September 4, 1984

UNCLASSIFIED
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MEMORANDUM FOR	OVP	- MR. G. PHILIP HUGHES
	STATE	- MR. CHARLES HILL
	DEFENSE	- COL. JOHN STANFORD
	AGRICULTURE	- MR. RAYMOND LETT
	COMMERCE	- MRS. HELEN ROBBINS
	OMB	- MR. ALTON G. KEEL
	CIA	[redacted] STAT
	USTR	- MR. DENNIS WHITFIELD
	NSC	- MR. ROBERT KIMMITT
	OPD	- MR. LEHMAN LI
	CEA	- MR. WILLIAM A. NISKANEN
	FED	- MR. EDWIN M. TRUMAN
	AID	- MR. MARK L. EDELMAN
	EXIMBANK	- MR. WILLIAM H. DRAPER, III

Subject Interagency Group on International Economic Policy (IG-IEP)

The agenda for the IG-IEP on Thursday, September 6, 3:30 p.m., in room 4426 of the Main Treasury Building will be the following:

1. Argentina
2. Mexico
3. Venezuela

Attached are discussion papers on Mexico and Venezuela. The paper on Argentina was distributed prior to the August 21 meeting.

Christopher Hicks
Executive Secretary and
Executive Assistant to the Secretary

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MEXICO - BACKGROUND FOR INTER-AGENCY GROUP

Overview

The Government of Mexico (GOM) remains committed to its IMF-supported economic adjustment program. Mexico's external accounts improved dramatically in 1983, reflecting further severe compression of imports and rescheduling of nearly $25 billion of external arrears and maturing debt to private and official creditors. The current account will not return to a deficit position until 1985, when economic recovery is expected to stimulate renewed demand for imports. Progress has been made in reducing inflation and the public sector deficit. A recovery is likely to materialize in 1985.

Mexico is regarded as the premier example of a successful adjuster. Reflecting this view, Mexico's leading commercial bank creditors agreed in June 1984 to negotiate a multi-year rescheduling of Mexico's debt to foreign banks. Talks are underway, but will be prolonged due to the number of complex issues to be resolved.

Status of the Economy

Mexico's trade surplus nearly doubled in 1983, reaching $14.5 billion, compared with $7.6 billion in 1982. A slight decline to $13.8 billion is expected in 1984, with a further drop, to $10.9 billion, in 1985 due to the impact of economic recovery on import demand. Mirroring these developments, the current account swung from a $5.2 billion deficit in 1982 to a $5.5 billion surplus in 1983. The surplus should drop to about $2 billion 1984; and a deficit of about $1.2 billion is expected in 1985. The peso has appreciated in real terms in 1984, due to higher than expected inflation. Although the peso is still somewhat undervalued, relative to a 1978 base, this trend appears to have stimulated some concern about the GOM's exchange rate policy and, with the added impetus of high real interest rates in the United States, given rise to increased capital flight. However, the GOM argues that the strength of the trade balance proves that the peso is appropriately valued and appears determined not to alter, at least for the remainder of 1984, its policy of depreciating the controlled and "free" rates by 13 centavos daily.

On the domestic side of the economy, progress has been made on the fiscal deficit, reducing it from nearly 18% of GDP in 1982 to 8.7% in 1983. A further reduction to 5.5-6.5% of GDP was planned for 1984, but there is some concern about the GOM's ability to meet this target. Although the GOM was within the target for the first half of the year, it is now increasing spending to stimulate economic activity. The rate of inflation is falling, dropping from over 100% in the year ending June 1983, to 81% in the year ending December 1983, and to 64.5% in the year ending July 1984. The GOM's original target of 40% for 1984 will not be met, with the rate currently expected to drop only to about 60%. Major sources of inflation have been increases in controlled prices and in the minimum wage (about 56% in 1984). The decline in real GDP appears to have been arrested, but private sector economic activity has been disappointing and the GOM is expected to increase public sector spending by an amount equivalent to 1% of GDP in the second half of the year to stimulate greater economic activity. Real GDP growth is unlikely to exceed 1% in 1984, but should be about 3.5% in 1985.

Multi-Year Rescheduling Agreement

The Bank Advisory Committee and Mexican officials have agreed on a multi-year rescheduling of public sector debt. The agreement rewards Mexico for having successfully implemented stabilization policies negotiated with the IMF. By signaling the commercial banks' willingness to reach favorable arrangements with countries that are successfully adjusting, the Mexican agreement may serve as an incentive for other major debtors to emulate Mexico's adjustment record.

The rescheduling agreement covers repayments due during 1985-1990, amounting to $43 billion. Of this total, $20 billion represents debt not previously rescheduled and $23 billion represents previously rescheduled debts. Mexico is to pre-pay (at the time rescheduling agreement enters into effect) $1.0 billion of the 1983 money package ($5.0 billion) and to make best effort to come up with an additional $500 million prepayment. Remaining balance of 1983 funds to be rescheduled at terms applicable to 1984 new money package. Repayment of all rescheduled debts to be concluded by 1998.

The average interest rate spread is 1 1/8% over LIBOR. Since this represents a reduction from the previous level, it is estimated by the Mexicans that it will save $350 million a year in interest payments.

Mexico also agreed to have the IMF monitor its economic performance. This will take the form of "enhanced" semi-annual Article IV consultations.

OASIA/IDN
September 4, 1984

VENEZUELA

The GOV is trying to chart its own path through the debt crisis, steadfastly resisting creditor efforts to have it accept an IMF arrangement, and proposing a novel debt restructuring scheme. The GOV has built its case for special treatment on a base of large reserves, accumulated in part by its failure to make private sector interest payments and amassing sizeable arrears, oil exports, and some success in its economic adjustment program, which has permitted the GOV to differentiate itself from its neighbors.

Nevertheless, the GOV faces substantial medium-term risks. Its economy, which has stagnated in the last six years, is inordinately dependent on oil. If the GOV's current plan to stimulate a private sector led recovery and diversification fail, it will most likely turn to expansionary fiscal and monetary policies, leading to inflation, and/or break its pledge to reduce its foreign debt over the next several years.

State of the Economy:

Six years of economic stagnation were capped by a 5% drop in real GDP in 1983, the worst performance in 30 years. Unemployment has risen sharply, from under 6% in 1980 to 13% in 1983, as per capita income has steadily declined. Inflation has been held in check, dropping to 6% in 1983, as the GOV has applied increasingly comprehensive price controls.

The GOV is projecting a gradual reactivation of the economy beginning in 1984 with a 1% rise in real GDP. The GOV hopes the recovery will be driven by the private sector, stimulated by the depreciated bolivar and import controls, but numerous disincentives to vigorous private sector activity need to be eliminated.

Furthermore, the GOV's plan to unify and fix the exchange rate at end-1985 could halt progress made towards adjusting import and export prices if the fixed rate coincides with loosening fiscal and monetary policies in the second half of Lusinchi's five year term.

Current Situation:

On July 25, after an 18 month delay, the GOV presented its proposal for the rescheduling of public sector debt to a commercial Bank Advisory Committee (BAC). The GOV proposed that 100% of included debt (privately held bonds and debt to official creditors was excluded) totalling $22 billion be rescheduled over 16 years including 1 year grace. The interest rate would be 7/8% over LIBOR with no Prime option. The most novel aspect of the proposal was a GOV request that a "level payments" mechanism be devised, which would hold total public sector debt service payments to about $4.2 billion per year.

On August 8, the BAC presented its counterproposal, which differed significantly from the GOV proposal. In particular, the BAC proposed a repayment period of 9-10 years including 2-3 years grace; a consolidation period of 1983-85; and a spread of 1.5% over LIBOR or 1.25% over Prime. The BAC also rejected the level payments concept.

Banks feel that, having reluctantly accepted the GOV's contention that it deserves different treatment (no IMF program) because it is financially stronger than other debtors, they should not be expected to turn around and provide Venezuela a very generous, and possibly concessional, rescheduling package. In the banks' view, the GOV proposal is more appropriate for a financial "basket case" and would impede the GOV's stated intention to return to financial markets for new (if not net new) money in the near future.

Banks also report that, administrative progress notwithstanding, private sector interest arrears are at an all time high of about $1.1 billion. Banks are described as "outraged" by the GOV failure to resolve the private sector arrearage situation.

Negotiations between the GOV and the BAC are continuing, but agreement will not be reached before a mid-September break for the Bank/Fund meetings. None of the central issues have been resolved, but initial positions have softened. The GOV seems resigned to dropping its "level payments" proposal, which banks criticized as inappropriately concessional given Venezuela's self proclaimed financial strength. For their part, banks seem to be moving towards consolidating virtually all public sector debt due to banks ($22 billion) and granting a repayment period close to the GOV request of 15 years.

On August 31 the IMF Executive Board reviewed the 1984 Article IV Consultations with Venezuela. IMF staff's assessment noted that the GOV had made noteworthy progress in its adjustment effort, particularly in the areas of the exchange rate and public sector finances. However, staff warned that continued price and exchange controls and some remaining weakness in public sector finances could stymie GOV efforts to end five years of economic stagnation by encouraging private sector activity. At the Board discussion Executive Directors affirmed that continued private sector arrears and the maintenance of "transitional measures" to protect the balance of payments impeded the restoration of confidence. Executive Directors also urged the elimination of the multi-tier exchange rate system.

Drafted by: Treasury/OASIA
August 30, 1984